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WHY INCOME PROPERTIES REMAIN YOUR BEST ROUTE TO A PROSPEROUS FUTURE

My telephone rings. I pick it up, and it's Dr. Cynthia Stephens from Los Angeles (where during the past three years property prices have jumped nearly 30 percent).

"I'm so worried," she says. "I think I've chosen the absolute worst time to buy a home."

I calmly assure her, "No you haven't."

"What do you mean?" she replies.

"Well, I'll tell you an even worse time to buy—five years from now, ten years from now, or any other time in the foreseeable future."

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Coincidentally, around the same time that I heard from Dr. Stephens, I was interviewed by *Business Week* (Susan Scherreik), *Fortune* (Brian O'Keefe), National Public Radio (Chris Farrell, Katherine Scott), *Smart Money* (Gerri Willis), *Mutual Fund* (Mark Klimek), the *Wall Street Jounral* (Terri Cullen), and the *New York Times* (James Schembari). In one way or another, each of these journalists asked similar questions and expressed concerns similar to those of Cynthia and many other homebuyers, investors, and journalists who frequently call me.

"Are we in a real estate bubble? Are properties still a good investment? Is it better to start switching money back to stocks? Can we expect property prices to stop appreciating? Won't stock returns outperform all other types of investments over the long run? Doesn't owning property create too many headaches? Shouldn't property buyers lay low until prices come back down?"

In two words, I answer all of these doubting Thomas questions with a resounding "Absolutely not!" Although no one can predict the short-term future, convincing evidence confirms that during the coming 20 years, people who own single-family homes, duplexes, quads, and small apartment buildings will continue to build wealth that they can count on. As a savvy real estate investor, your properties will outperform stocks because your profits will build in six ways:

1. A dependable and growing flow of income
2. Value increases (appreciation)
3. Mortgage payoff (amortization)
4. Value creation (property improvement)
5. Instant gain (bargain purchase price)
6. Government benefits (tax credits, tax deductions, rent vouchers, advantageous loans, etc.)

In the chapters that follow, you will discover how to make each of these sources of return work best for you. You will discover how income properties can provide you a near certain path to financial security and prosperity. But before you begin that journey, first carefully examine the economic and demographic evidence that firmly supports strong gains for investors who choose real estate.

REVIEW THE PAST *AND* FORECAST THE FUTURE

All too frequently, authors try to guide their readers with lessons learned from history and experience. You know the line: "This worked for me, so it will succeed for you." While that approach offers some credibility, it's certainly not the end of the story. Markets change. Opportunities ebb. What worked yesterday may not work tomorrow.

So I'm not merely going to persuade you with tales about the riches earned by property owners of the past (myself or others). More importantly, before you invest time, energy, intellect, and money, you're invited to envision the future. You must ask, "Do emerging demographic trends still point to profits? Do reasonably expected returns justify the price you're required to pay? Does a downturn in the housing market signal a great time to buy, or a quick trip to the exit? Will more (or less) inflation spell boom or gloom for your investment? Given what we know about the unfolding future, what investment offers the best returns along with the most controllable risks?"

Today, investing profitably stands critical to your health, wealth, and peace of mind. With pension plans, the stock market, social security, and lifetime jobs all engulfed in a fog of uncertainty, you must take investing more seriously than any previous generation in U.S. history.

With this seriousness in mind, then, we will explore the answers you need to the foregoing questions. You are not advised to choose income properties because they have yielded superior profits in the past. You are encouraged to own property because provable economic and demographic facts confirm a profit-generating future.

A DEPENDABLE AND GROWING FLOW OF INCOME

During the bull run of the late 1990s, dot-com investors forgot a central truth: The justifiable price of an investment never exceeds the present worth of the income that investment can reasonably be expected to generate. Of course, these dot-com investors (speculators) don't stand alone in history. The same story with the same results has been told a hundred times before: Amsterdam tulip bulbs in the 1700s, the Florida land boom in the 1920s, the stock market craze for conglomerates in the early 1970s, Houston apartments in the early 1980s, Boston condominiums in the late 1980s, and maybe Silicon Valley houses since 2000. Fate offers no safe escape for the foolish or greedy.

Before you choose an *investment,* you must weigh the amounts of *income* (rents, dividends, or interest) that investment is likely to yield relative to other potential investments. Is the flow of income dependable? Will it grow over time? Will it guard you against inflation?

Always recognize this truth: An investment that falls behind other types of investments in terms of income must (sooner or later) suffer in value. In contrast, investments that yield superior flows of income will show higher rates of long-term appreciation. *Investors* never buy assets, per se. They buy flows of future income.[1] With that said, let's see how income properties stack up against stocks, bonds, and annuities.

Property versus Stocks

Compare two investors, Sarah and Roy, who have each accumulated investments worth $1,000,000. Sarah owns rental houses; Roy owns

1. For the definitive exposition of this critical (yet too little understood) point, see John Burr Williams, *The Theory of Investment Value* (Cambridge: Harvard University Press, 1938).

stocks. Who is likely to achieve the most annual income? The average dividend yield on stocks has been bouncing around 1.4 percent—a near record low.[2] In contrast, the dividend yield (i.e., net operating income) on rental houses and small apartment buildings (owned free and clear) typically falls within the 6 percent to 12 percent range. Let's say Sarah's properties yield around 8 percent.

Based on these respective yields, the corporate management of the companies in which Roy owns stocks would mail him checks totaling $14,000 a year. As a reward for owning income properties, Sarah's property manager would mail her checks totaling $80,000 a year.

Even if we assume that Sarah's current returns from property actually fall in the low range (say, 6 percent) and that Roy achieves a dividend yield from stocks that's double the S&P average (say, 2.8 percent instead of 1.4 percent), Roy's stocks will pay him only $28,000 per year versus the $60,000 a year that Sarah's real estate will pay her. Note, too, that we've ignored income taxes. In real life Roy's dividends will be fully taxed as ordinary income, whereas Sarah's rental income will (in part) escape taxation due to tax breaks for the noncash deductions of depreciation.

Also, to keep matters simple, we didn't count leverage (discussed in Chapter 2). Through long-term mortgage financing, Sarah could greatly boost the amount of property cash flow that her $1,000,000 yields. By using mortgage money to help her buy more properties, Sarah could actually pull in $100,000 to perhaps as much as $140,000 a year.

Unfortunately, Roy can't use borrowed money to enhance his yearly income from dividends. He would have to pay interest on his margin account at the rate of 8 percent to 12 percent a year. Yet he earns an annual cash return of 3 percent or less. Even the mathematically challenged will realize that Roy could soon go broke following that losing strategy.

The Nest Egg Dilemma. Financial planners are gradually beginning to acknowledge the problem that low dividend yields create for stock market investors. Absent a much larger cash-on-cash return, relatively few Americans can ever hope to accumulate a stock market nest egg large enough to provide them a livable income in their later years. In recognizing this fact, financial Web sites now display "retirement calculators" that presumably help you figure out safe rates of portfolio liquidation. The "stocks for retirement" crowd now admits that to live comfortably, future retirees must plan to eat much of their seed corn. Yet anytime you consume capital, you face the risk that you will run out of money before you run out of life.

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2. Each issue of *BusinessWeek* reports the latest dividend yield in its "Figures of the Week" section, which is regularly found in the magazine's back pages.

On the other hand, if you just nibble your seed corn conservatively, you will probably have to give up your golf club membership, your frequent dinners at Café à Riche, and those cross-country trips to visit the kids.

Because stocks don't produce much income, retired stock investors are pinched between that proverbial rock and a hard place: (1) Draw down cash too quickly, and you end up living on food stamps and Section 8 housing vouchers; or (2) spend cautiously, clip coupons, search out every senior discount you can find, and you miss the enjoyable lifestyle that accumulated wealth should make possible.

Volatility of Returns. More bad news for those who want to count heavily on stocks for the long run. We return to March 2000. The S&P is flying high, and the NASDAQ has sailed into the stratosphere. Your plans to retire comfortably at age 55 in the year 2006 are moving along quite nicely. In fact, you're already shopping for a vacation-retirement home. Then, wham! You're hit with previously unimaginable losses. During the next two and one-half years, the value of your portfolio sinks 40 percent. By July 2002, it's fallen back to where it was in 1996—six years earlier. What do you do?

Up until March 2000, most investors erroneously believed that the stock market just plugs along dependably, handing out appreciation gains of 10, 12, or 16 percent year after year. Market blips? No worry, the S&P will surely bounce right up again. Only recently have these investors begun to learn that depressed markets don't always roar to new highs. Bear markets can sometimes slumber for decades (e.g., 1907–1924; 1929–1954; 1964–1982).

And that unhappy fact presents another type of stock market nest egg dilemma: If, over the next 20 years, you want to build a nest egg of $1,000,000 (today's dollars), how much do you sock away each year? No one knows the answer.

You can assume stock market appreciation of 6, 8, 10, or even 12 percent a year. But persistent (and sometimes lengthy) ups and downs of the market render financial planning tougher than predicting sunny days in Seattle. Not only do stocks fail to yield a high level of income, but you can't even reliably estimate the amount of income (or wealth) you will receive. Stock price volatility along with low dividend yields can shatter the best-laid nest eggs.

What about Bonds?

Quality bonds typically pay more annual income than stocks, but they still lag returns from income properties. However, let's say that to boost his income, Roy moves his portfolio from stocks that earn a dividend yield of 2.8 percent to 30-year bonds yielding 7 percent. Sounds good until you think longer term. Unfortunately, that $70,000 a year that Roy now receives in interest will remain at $70,000 year after year for the next 30 years. This annual income will never go up, and its purchasing power will continue to fall. If the consumer price index (CPI) advances at an average annual rate of 3 percent during the next 20 years, that $70,000 of bond interest would yield a purchasing power in today's dollars of just $38,757; after 30 years, $28,839.

Now compare this bond interest with Sarah's (low) current rental income of $60,000. The bond interest looks better for now (income taxes aside). Over time, though, Sarah's rental income will continue to increase by 3 to 5 percent a year. If Sarah's properties average a 4 percent rent increase each year, here's how her $60,000 of net income could grow:[3]

5 Years	*10 Years*	*20 Years*	*30 Years*
$72,900	$88,700	$131,300	$194,325

Investors must recognize that income properties are called *income* properties not only because they yield competitively favorable incomes today but also because that income will multiply itself over time. For future income that you can live well on for as long as you live, no investment comes close to matching the amount and certainty of income provided by properties that produce ever-growing rental revenues.

Don't Fall for the Annuity Sales Pitches

With stock market jitters and low CD rates rattling the retired and near retired, peddlers of annuities have tried to grab an increasing share of the investment and savings dollar. One such company regularly runs an ad in the *Wall Street Journal* with the following headline:

> **Lock in 6.00 Percent Interest Rate**
> **Fixed annuities are today's ideal investment. Compared to dividend yields of less than 1.5 percent and CD rates of 2.5 to 5.0 percent, 6.00 percent interest might seem attractive.**

But as with bonds, fixed annuities expose you to substantial inflation risk. Even worse, as with stocks, to pay a decent income, annuities must con-

3. Actually, a 4 percent increase in rents would typically produce more than a 4 percent gain in cash income. But for now, we'll keep this example perfectly simple.

sume your capital. Just as bad, many annuities include heavy front-end expense loads and fees in addition to early redemption fees. Don't be misled (as my retired parents almost were). Most people cannot wisely use annuities to satisfy their need for a sufficient, dependable, and growing source of income. And if you get in and want out, you will pay dearly for that privilege.

Are Rent Collections Dependable?

"Okay," you may be saying, "You've convinced me that dollar-for-dollar rental properties throw off more income than stocks, bonds, CDs, or annuities. But what about vacancies and deadbeat tenants? Who needs that kind of headache?"

Good point. That's why Chapters 11 and 12 show you how to manage your rentals with minimal time, effort, and risk. When you follow the policies and practices discussed later in this book, you will see how to achieve low turnover, high tenant retention, and an eager waiting list of good people who will prefer your properties to inferior rentals offered by other owners.

Review Your Market. As a check on what I say, review your local rental market. Can you find any well-located, well-kept houses or (competently managed) small apartment buildings that remain available for rent for any lingering period of time? Probably not, especially if they're priced and promoted effectively. Except in isolated cases, smaller residential rentals typically suffer vacancy and collection losses of less than 5 percent per year.

Beware of Superficial "Market" Vacancy Rates. As I write, news stories are reporting increasing apartment vacancies, falling rents, and increasing use of rental concessions. Nationally, average apartment vacancy rates have climbed above 6 percent.

Beware of putting too much meaning into these types of "market" averages. Typically these averages do not pertain to the types of properties that you will own. Instead, so-called market vacancy rates and rent concessions primarily apply to two types of properties: (1) apartment megacomplexes whose hundreds of units persistently suffer revolving-door occupancy, and (2) ill-maintained properties that attract the dregs of the human populace.[4]

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4. For example, I recently received a Department of Housing and Urban Development (HUD) foreclosure offering for a 22-unit rental property that not even rats and cockroaches would want to call home. Of the 22 units, only 9 were occupied.

Don't misunderstand. By citing the misleading nature of market averages, I don't imply that a glut of new construction (houses, condos, or apartments) or a severe uptick in unemployment will never pressure small investors to reduce their rents. Even owners of well-managed small properties must adapt to the law of supply and demand. Over time, though, nearly all competent property owners will enjoy increasing amounts of rent receipts. (Severe underbuilding always follows excessive overbuilding.)

Why Rents Will Continue to Increase

Although short-run economic downturns may jack up vacancies and depress rents, rent levels will go up over time because future demand will increase faster than future supply. Here are four reasons why:

1. *Population growth.* During the next 20 years, moderate projections show that the U.S. population will grow from a current population of 280 million to a nation of 330 million—an increase of 50 million people. In just two decades, the United States will add more people than currently live in the states of Florida and California.
2. *Household growth.* To adequately house this population increase will require a net gain of 20 to 25 million housing units. Americans now average about 2.3 persons per household. But given the relative decline of families with children, more singles living alone, and a bulging contingent of empty nesters (as boomers move into late middle age and retirement), the per-person-household figure could fall to around 2.0.
3. *Incomes.* To rent or buy homes and apartments, people need money. Correspondingly, people earn more money when the U.S. economy becomes more productive. Fortunately, the outlook for productivity remains bright. Technological innovation, higher levels of education, heightened competition among businesses, and continued corporate cost cutting will bring strong gains in productivity and incomes. The ever-growing number of two- (or more) earner households also adds measurably to household buying power.
4. *Second homes.* At present, around 7 million households now own second homes. Nearly all forecasters expect this number to mushroom during the next two decades. By 2025, 15 to 20 million households will own two or more homes.

From Baby Bust to Echo Boom

From 2000 to early 2003, some rental markets did soften. Partly, that weakening reflected low (nominal) interest rates that caused many renters to realize that they could own for less than they were paying to rent. Just as important, this softening reflected "baby bust" demographics.

For the past several years, the largest renter demographic segment (ages 25 to 34) has significantly fallen from its previous high levels, and that fall was especially steep between the ages of 25 and 30. For contrast, consider that during the late 1980s and early 1990s, approximately 26 million baby boomers occupied the 25 to 30 age group, whereas by 2002, the population of 25- to 30-year-olds had hit a low point of approximately 20 million. (From the early 1970s through 1978, the number of U.S. births averaged just 3.2 million a year—a post–World War II low—whereas previously, during the early to mid 1960s, parents produced around 4.2 million babies a year.)

In looking to the future, an emerging wave of echo boomers spells profits for income property investors. In 1978 the nation began to experience a wave of increasing births (often called the echo boom). During the 18 years thereafter, births steadily climbed from around 3.5 million to approximately 4.1 million per year. (Do you recall the boom in housing markets of the 1970s? Prepare for a repeat performance.) To the benefit of investors, this steadily emerging number of echo boomers will compete mightily for their first apartments and starter homes.

You can now easily see that the approaching decades will produce near record levels of new renters and homebuyers. Property owners will continue to enjoy strong upward pressures on both rents and home prices. "But wait," you say. "Aren't you forgetting about supply? Won't builders again go into fits of construction frenzy and glut the market?" No. Here's why.

New Construction Can't Keep Pace

In the academic world of economic theory, supply increases to meet demand. Extensive competition thus tightens the leash on runaway price increases. For Big Macs, long-distance telephone rates, and airfares, this theory works pretty well. But housing prices can't be tamed as easily. Absent some completely unforeseeable events, builders won't be able to construct all of the homes and apartments that people will want. In housing markets, builders and developers are tightly leashed by five factors:

1. *High costs.* Most people can't afford to buy or rent new construction. The median price of a new home now approaches $175,000. To build new apartment complexes, developers typically spend upward of $90,000 per unit. And unlike AT&T, Ford, and Compaq, home builders can't easily slash costs through economies of scale or massive layoffs.
2. *Lack of land.* Although in total the United States enjoys an abundance of land, most of it isn't located where people want to live. And when it does sit in a choice location, you can bet that it's premium priced.
3. *Cumbersome regulatory approvals.* Large-scale land development requires dozens of costly and lengthy government permits. Major developments require an investment of many years and millions of dollars before the first house or apartment unit is ever built.
4. *NIMBY power.* Even if builders are able to weave their way through the webs of bureaucracy, they must increasingly face off against a battalion of upset neighbors, environmentalists, and a variety of so-called public interest groups (PIRGs) who want to influence (restrict) development.
5. *Inadequate infrastructure.* New developments require additional (or expanded) roads, schools, parks, waste disposal and water systems, and recreational areas. In cases where developments lack adequate infrastructure, governments frequently block new construction or alternatively assess builders thousands of dollars per unit in impact fees.

Taken together, these five restrictions mean that the housing market can't quickly and economically respond to bursts of demand. No doubt, some local markets will from time to time produce an excess of "for rent" and "for sale" signs. But in most times and places, builders will play a perpetual game of catch-up. Over the next 20 years, rental property owners are sure to profit from the constrained supply of new construction.

MORE GOOD NEWS FOR PROPERTY APPRECIATION

You now know that market fundamentals (i.e., renters and homebuyers with money and limited housing choices) will push rents and property prices to successive new highs. But that's not the whole story behind strong appreciation. We can also expect to see more investors bidding up the prices of houses and apartment buildings.

But First, the Reckoning

Today relatively few of America's 60-plus million stock market investors seem ready to shift their portfolios from equities to income properties. Most of these investors remain deterred by two false beliefs:

1. *The perils of landlording.* According to this myth, owning properties means spending Saturdays with a pipe wrench under a tenant's sink and taking calls at midnight to deal with a stopped-up toilet. As someone who has owner-managed as many as 32 houses and apartment units at one time, I can assure you that I have never once repaired a sink, roof, or stopped-up toilet. Nor did any tenant ever call me outside the hours of 8:00 A.M. to 8:00 P.M. (and even those calls were rare).
2. *Stocks for the long run.* The second false belief that deters investors from rental properties is the mantra "Over the long run, stocks will outperform all other investments." During several recent weeks of stock market turmoil, I've read a dozen or more personal finance articles telling investors to hang tight. All will turn out well for those who keep the faith.

Naturally, the Wall Street public relations machine otherwise known as the financial press must perpetuate these two myths to keep their advertisers happy and their circulation numbers high. Think about it. Look through *Kiplinger's Personal Finance, Money, Bloomberg, Smart Money, Forbes*, and *Barron's.* Who buys the ads in these publications? Mutual funds, insurance companies, and stock brokerage firms. How many of these advertisers would stick with a publication that told the truth:

SUBSCRIBER ALERT!

The stock market cannot and will not provide 50 million Americans the income they will need for a prosperous and secure future.

How would readers of these publications respond if they discovered that picking stocks (or mutual funds) can't yield the riches they've all been promised? Mass cancellation of subscriptions, plunging sales at newsstands, that's how. The financial press must try to keep the dream alive. Otherwise they too will hit hard times.

Yet I'm confident the truth will eventually prevail.[5] Even without boldface, full-page announcements in the financial press, many thoughtful investors will come to realize that stock market math does not add up. It's not possible to spread the relatively small and finite amount of available corporate dividends among 50 million (or more) retired Americans and expect these retirees to feast for the rest of their lives. A day of reckoning becomes inevitable.

The Relevance to Property Appreciation

Thoughtful investors pay attention to the relative *expected* returns among asset classes. So congratulations to you. You're to be counted within that wise group. By virtue of the fact you're reading a book on investing in real estate, you already suspect that stocks offer too little expected return for too much risk. But potentially, millions of other investors are standing behind you. They, too, will eventually awake to the predominantly inferior risk-reward relationship for stocks vis-à-vis income properties.

When that reckoning hits (indeed, the trend to property investment has already turned upward), cash-on-cash yields will be pulled down as property prices are pushed up.

Here's How the Numbers Work. Property investors typically value income properties according to a simple formula:

$$\text{Value} = \frac{\text{NOI } (\textit{net} \text{ operating income})}{\text{R } (\textit{capitalization} \text{ rate})}$$

NOI equals gross rent collections less all operating expenses such as repairs, maintenance, property taxes, and insurance. R equals the unleveraged (i.e., no financing involved) prevailing rate of return for a given locale and property type (house, condo, quad, 16-unit). (You'll find a full explanation of this value formula in Chapter 3. For now, though, we'll focus on the basics.)

Throughout much of the United States, cap rates (Rs) range between 8 and 12 percent. Say you're looking at a six-unit property with a net operating income (NOI) of $24,000 and a local market-based R of 10 percent.[6]

5. For a detailed risk/return comparison of stocks and income properties, see my book *Value Investing in Real Estate* (New York: Wiley, 2002).

6 .Earlier we assumed that Sarah bought single-family houses. Quite often, houses carry a lower cap rate (R) than apartment buildings.

With numbers like these, the present owner could sell the property for around $240,000.

$$\text{Value (selling price)} = \frac{24{,}000 \text{ (NOI)}}{.10 \text{ (R)}}$$

$$V = \$240{,}000$$

Now think back to that 1.4 percent market dividend yield for stocks discussed earlier. At that level of yield, a $240,000 investment in stocks will pay only $3,360 (.014 x $240,000) in annual income. When property owners earn a 10 percent (more or less) income yield from real estate, why would sensible investors buy stocks? Because they hope stock prices will appreciate strongly.

Now comes the tough question: Why would anyone expect an asset that yields around 1.4 percent to appreciate strongly and thus drive down its cash-on-cash yield even further? Does the term "irrational exuberance" come to mind? As investors get closer to the age when they need or want income (or as they lose "irrational patience"), more and more of them will bid for the more bountiful cash flows provided by rents. Next you'll see too many new investors chasing too few good properties. Sellers will then force buyers to accept lower yields. Cap rates (R) will fall. Property values will jump even higher. How far will yields drop? No one can say for sure. But in coastal California and other low-yield real estate markets, you frequently find cap rates (R) of 6 percent or less. Here's a glimpse of the potential price-lifting effects of lower cash-on-cash yields (i.e., cap rates):

$$\frac{\$24{,}000 \text{ (NOI)}}{\mathbf{.09} \text{ (R)}} = \$266{,}666 \text{ (V)}$$

$$\frac{\$24{,}000 \text{ (NOI)}}{\mathbf{.08} \text{ (R)}} = \$300{,}000 \text{ (V)}$$

$$\frac{\$24{,}000 \text{ (NOI)}}{\mathbf{.07} \text{ (R)}} = \$342{,}857 \text{ (V)}$$

$$\frac{\$24{,}000 \text{ (NOI)}}{\mathbf{.06} \text{ (R)}} = \$400{,}000 \text{ (V)}$$

$$\frac{\$24{,}000 \text{ (NOI)}}{\mathbf{.05} \text{ (R)}} = \$480{,}000 \text{ (V)}$$

Cash Yields plus Higher Rents. Where precisely yields come to rest depends on a variety of factors. But one face stands firm: The yield spread between stocks and properties is much too wide to persist. Any investor who buys before R reaches bottom will receive a nice appreciation bonus. But if you act now, here's an even better offer. Your property appreciation won't merely reflect the price-lifting effects of lower yields. You will also gain as the growing numbers of echo boomers (and millions of recent immigrant children) bid up rents as they compete to acquire a place of their own.

Say you buy a six-unit today for $240,000. Five years pass. Rents have gone up. Yearly NOI for the property has climbed from $24,000 to $30,000. Yield (R) has dropped from 10 percent to 8 percent. Your $240,000 property now sports a value of $375,000:

$$\frac{\$30{,}000\ (\text{NOI})}{.08\ (\text{R})} = \$375{,}000\ (\text{V})$$

The Interest Rate Kicker

As the cost of 30-year mortgage money hovered in the 6.0 to 6.5 percent range during the summer of 2002, journalists persistently oohed and aahed over the "historically low" interest rates. They told us that rates couldn't stay at this rock-bottom level. By the end of the year, interest rates would surely move higher and thus puncture the housing bubble that these low rates had pumped up. But it didn't happen. Rates stayed lower and lower.

"Historically Low" Rates? Not Even Close. At some point, however, *short-term* mortgage costs may rise. And even with the approaching growth of the echo boomers, steady double-digit home price gains won't continue without respite. Exhausted buyers in some frenzied markets must choose to take a breather—regardless of where interest rates go. So my analysis hereafter doesn't challenge the possibility of short-term rate boosts and localized dips in home prices.

However, to forecast *longer-term* property appreciation, investors must not accept the erroneous notion that 6.0 to 6.5 percent mortgage rates sit anywhere near their historical lows—and therefore over time must trend upward. Indeed, in real (inflation-adjusted) terms, mortgage rates during 2002 floated near their historical highs. Once you understand that fact, you will see why during the coming years, 15- to 30-year mortgage rates could drop to 5 percent or lower. If that drop does occur, property investors will receive an astonishing appreciation kicker.

Table 1.1 Historical Nominal and Real (Inflation-Adjusted)

Year	Nominal Rate	CPI Increase	Real Rate
1945	4.0	2.3%	1.7
1950	4.5	1.3	3.2
1955	5.0	–0.4	5.6
1960	5.0	1.7	3.3
1965	5.89	1.6	4.29
1970	8.56	5.7	2.86
1975	9.14	9.1	.04
1980	13.95	13.5	.45
1990	10.08	5.4	4.68
1995	7.86	2.8	5.06
2002	6.5 (est.)	1.5 (est.)	5.0 (est.)

Nominal Interest Rates. Recent mortgage costs have seemed historically low only because most people don't know that from the 1940s through 1965, U.S. mortgage rates steadily ranged between 4.0 and 6.0 percent. In fact, during some periods of U.S. history, mortgage interest rates have dropped as low as 2.5 percent.

The mortgage rates of 8 to 14 percent that prevailed throughout most of the 1970s, 1980s, and 1990s do not represent a reasonable norm against which we should judge today's rates. High nominal interest rates prevailed throughout most of the past 30 years because we also experienced (and then came to expect) historically high rates of inflation.

CPI-Adjusted (Real) Rates. In other words, to truly understand whether recent interest rates sit high or low, you must adjust the nominal (quoted) rates for the annual rate of increase in the CPI.[7] The cost of money is cheap when *real* rates are low, and expensive when *real* rates are high.

As you can see from Table 1.1, mortgage borrowers today are paying historically *high* real rates of interest. Viewed correctly, history suggests that—as long as Federal Reserve Board chairman Alan Greenspan (or his successor) keeps inflation low—nominal *and* real interest rates are likely to continue their downward trend during the next 5 to 10 years. With the Federal Reserve's dedicated resolve, the mortgage rate levels of the 1940s, 1950s, and early 1960s could return.

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7. The nominal mortgage interest rate less the annual percentage increase in the CPI equals what economists call the *real* rate of interest.

Should that fortunate turn of events come to pass, property prices would spike upward again. Lower interest means lower monthly payments; lower payments mean investors and homebuyers alike could (and would) pay more for their properties.

More Good News: Even Higher Interest Rates Can Spur Greater Property Appreciation. Assume that for some unforeseen reason, inflation does again rear its ugly head. The Federal Reserve Board fails to tame this unruly monster, and mortgage interest rates reverse course and run up past 10 percent. What would happen to the prices of investment properties? In the short run, property prices could fall. But not necessarily. When interest rates steadily rose higher and higher between 1965 and 1980, housing appreciation rates generally remained strong. Here's why.

More Inflation, Higher Building Costs. Inflation not only drives up interest rates but also drives up the costs of construction. Builders suffer. Their potential buyers retreat in the face of much higher mortgage payments and more difficult qualifying. Owing to a much-changed profit outlook (fewer buyers, higher costs), builders shut down job sites. They wait for the storm to pass. Fewer new houses and apartments get built. Existing properties appreciate until their prices climb high enough to again make wide-scale building profitable.

More Inflation, Investors Flee to Hard Assets. Have you noticed how the financial news folks track Mr. Greenspan's moves as closely as hounds track a fox? Whenever the Fed signals that inflation could reappear, stock and bond prices take a hit. Investors flee Wall Street securities in favor of hard assets like real estate. Investors know that a skyward-bound CPI wipes out the values of financial assets (e.g., 1965–1982). If you anchor on a rising tide, your boat gets swamped. In response, property prices gain as investors rush to rebalance their portfolios with inflation-protected rental revenues.

*More Inflation, Higher Rents, Greater Profits***.** In other words, as an owner of income properties, you'll gain during a period of inflation because tenants will pay you higher rents. Even better, if you've financed your properties with a fixed-rate mortgage, your largest expense (mortgage interest) will stay low. If you've financed your properties with an adjustable-rate mortgage (ARM), unexpectedly high inflation may still lift your net cash flows.

Your ARM's interest rate adjustments will be capped. The interest rate you pay may still lag the market rate. Or your lender may have tied your ARM increases to a slow-moving index. Without bringing the ARM cap into play, your interest rate may still rest firmly below market. And because loan terms often permit new buyers to assume an adjustable-rate mortgage, your below-market interest rate would tempt investors to pay you a premium price for your property.

REASON, NOT FAITH

When it comes to investing, facts eventually expose illusions. Eventually reason trumps faith. Today more than 80 million Americans need to invest successfully. Most of us can no longer count on a lifetime job, a large pension, or social security to guarantee our financial prosperity—or survival. Yet most investing Americans still believe they can find salvation in stocks. They keep plugging money into their 401(k)s, 403(b)s, IRAs, Keoghs, and 529s. They keep chanting, "Stocks for the long run."

Stocks Can't Deliver

Unfortunately, the stock market can't deliver the bounty that these tens of millions of people are expecting. Mathematically, corporations don't (and can't) pay high-enough dividends to satisfy the income needs of hopeful investors. And no investment can show sustained appreciation without yielding a competitively strong flow of income.

Sure, some people will win the stock market game. They will buy and sell the next Microsoft or eBay at precisely the right times. But for the great majority, disappointment must prevail. The number of players in this poker game has multiplied ten times faster than the size of the pot.

You Can Still Win with Income Properties (for Now)

The discussions throughout this chapter have provided the facts and reasoning to support my advocacy of income properties. All reasonable views of the future show more and more people chasing after a limited supply of homes and apartments.

In addition, the gaping cash-on-cash yield spread between stocks and property clearly indicates that sooner or later (probably sooner), investors with retirement in their sights will rebalance their portfolios toward property, thus putting more pressure on property prices. In terms of both expected income and appreciation, income property currently remains your best route to wealth and financial security.

Use Your Reasoning to Beat the Market. Although the market forces of supply and demand look favorable for property, you can do even better.

In the chapters that follow, you will learn how to enhance your profits through intelligent use of leverage (mortgage financing), bargain hunting, sharp negotiating, creative improvements, strategic management, and tax avoidance (not evasion). As you develop knowledge and talent with each of these skills, you will be able to earn good profits—even when markets temporarily turn down. (In fact, as an investor, I much prefer down markets. Down markets offer choice buying opportunities. Bargain prices, creative financing, and foreclosures become abundant. Don't fear a down market. Take advantage of it.)

The General Problem: Opportunities Will Get Tougher to Find. When, as a college student, I began buying investment houses and apartments, I encountered few competing investors. I could find bargains any day of the week. Cap rates of 12 to 16 percent were common. I frequently earned (with financing and tax shelter) annual after-tax, cash-on-cash yields of 30 to 50 percent. Owner financing was typically available for the asking.

Indeed, to show how much prices and cash yields have worsened for today's new investors, I urge you to read the late William Nickerson's *How I Turned $1,000 into $1,000,000 in My Spare Time,* or David Schumacher's *The Buy and Hold Real Estate Strategy.*

Please, though, don't take away the wrong message. I don't bring up the easier past to discourage you with an "it's too late, you've missed your chance" attitude. Instead, you must see the trend. All types of investing present more difficulties today. And no doubt, investing will become even more difficult in the future. Too many people with money are chasing after too few good investment opportunities.

In the past, most Americans worked hard without any thought of living 15 to 30 years after the age of 65. Retiring at age 55 was unheard of—unless your last name was Rockefeller, Ford, or DuPont. Now, tens of millions of us expect and desire both longevity and prosperity. How will we all succeed? We can't. Stocks, bonds, real estate? Even if you total the income from all of these investments, you still can't come up with anywhere near enough money to fund the hopes and dreams of everyone.

The Solution: Start Now. Times are tougher. Prices are higher. So, should you wait? Absolutely not. In the early 1990s, the press overwhelmingly told Americans not to buy real estate. They said, "Housing is no longer a good investment." Two Harvard economists published a widely quoted article that predicted housing prices were about to collapse. These economists forecast that by 2002 housing prices would sit 40 percent lower than in 1989.

I took the opposite view. In my 1993 book *Stop Renting Now!* I told Americans to get off the sidelines. Get into the game now! Housing prices would soon climb to startling new heights.[8] For the reasons stated in this chapter, I make the same forecast today. By the year 2013, you will see prices and rents shoot up as much as (or more than) they did between 1993 and 2003. I also predict that cash-on-cash yields for rental properties will continue to fall. The baby boomers will be scrambling for their retirement incomes.

So, as I first wrote 10 years ago, I similarly advise you now. Get into the game. Develop your knowledge and talents. Select your strategy (from those discussed later). Put your strategy and goals in writing. Then execute, execute, execute. Played skillfully, the game of real estate will reward you with not only a prosperous life but also the thrill of the chase.

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8. In the first edition of my book *The 106 Common Mistakes Homebuyers Make—and How to Avoid Them* (1994; 3d ed., 2002), I listed two mistakes as fatal: number 105, “We aren’t buying. We’re afraid of making a mistake,” and number 106, “We thought it over. We think we’re better off renting.”